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Auditor's opinion on the basis of a restricted examination : (no. 2) ; Statements on auditing procedure, No. 11

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Statements on Auditing Procedure

No. 11

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The Auditor's Opinion on the Basis of a Restricted Examination (No. 2)

THE COMMITTEE previously expressed itself regarding the circumstances in which it would not be proper for the independent auditor to express an opinion.¹ In "Extensions of Auditing Procedure"² it was stated:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

Questions arise however, in particular cases as to whether or not the exceptions are of such materiality as to negative the opinion. Bulletin No. 2 issued by this committee dealt with one case where the facts led to the conclusion that the items and transactions involved in the exceptions were so material that there seemed to be insufficient basis for even a restricted opinion and it was concluded that the auditor should refrain in the particular situation from expressing any opinion at all.

Another case was recently presented to the committee, and since the committee took the position that a restricted opinion might be proper in this situation, it is the belief of the committee that the case might be of sufficient interest to the membership to merit presentation in a formal statement by the committee. In this particular case, several questions were involved, but the present statement deals only with the major question of the propriety of a qualified opinion.

The company involved is a federal savings and loan association operating under the rules and regulations promulgated for such associations

¹ Statements on Auditing Procedure No. 2, "The Auditor's Opinion on the Basis of a Restricted Examination."

² Statements on Auditing Procedure No. 1.

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by the Federal Home Loan Bank Board. In accordance with the request of his client, the independent accountant who had been called in by the association to make an audit did not independently confirm mortgage loans, share loans, and shareholders' accounts, although such confirmation was practicable and reasonable and was called for under the rules and regulations for the Federal Savings and Loan Associations which require that the examination shall be based upon the audit program outlined in the "Audit of Savings and Loan Associations by Independent Certified Public Accountants" published by The American Institute of Accountants in July, 1940. Subsequently, the independent accountant rendered his report and stated that, with the exception of the confirmation of the above stated accounts, in his opinion the examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which he considered necessary; but the auditor did not render an opinion as to whether or not the balance-sheet fairly presented the position of the association as of the audit date.

The agent in charge of the Federal Savings and Loan Insurance Corporation took the position that the rules and regulations called for an opinion on the part of the independent accountant, even though it were qualified. The auditor was uncertain, however, whether he could properly render an opinion qualified to so great an extent and sought the advice of the committee. The response on behalf of the committee was as follows:

"The committee on auditing procedure has so far not attempted to state with any particularity the circumstances in which, under the rule mentioned, the exceptions should be considered as sufficiently significant to prevent the proper rendering of an opinion. The nearest that the committee has approached such a statement is in the paragraph contained on page 57 of Bulletin No. 8 where rather extreme cases of minor and major exceptions are given. The difficulty lies in drawing a dividing line at the proper point between these two extremes and in stating conclusions which depend on circumstances existing in the individual situation.

"In the instant case you have not furnished particulars as to the amount involved in the mortgage loans, loans on pass books and certificates, contracts for the sale of real estate, and accounts being dealt with by the association's attorneys, but presumably, in view of the nature of the organization, these would represent a very substantial portion of the total assets.

"Inasmuch as the examination is stated to have been made in conformity with generally accepted auditing standards in other respects it is clear that the customary examination of documents and the book records has been undertaken. As you have not stated otherwise it may be assumed that as far as you have pursued your examination it has proved satisfactory. There is not a complete absence of auditing procedures in respect to the items

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involved but solely of the confirmatory procedure of communication with debtors. From the fact that you have not stated otherwise, it can be assumed that you consider it practicable and reasonable to make such confirmation. This is evidently the case as you state that the Federal examiners have heretofore done it.

"One of the criticisms, and perhaps the major one, directed at auditing procedure which led to the adoption of 'Extensions of Auditing Procedure' was that the auditor did not have sufficient direct contact with the assets of the organization. Thereafter he was called upon to have physical contact with the inventories and to communicate with debtors where these items were important. The omission of confirmation in the instant case would probably leave the auditing procedures subject to this major criticism because there are, presumably, substantially no other assets in respect of which the auditor can go beyond the company's records.

"The situation thus narrows itself down to the question whether the omission of a particular and important auditing procedure in respect of a major portion of the assets is sufficient to preclude the expression of an opinion.

"In dealing with this question it is necessary to consider what are the possibilities of material misstatement which could occur as a result of the failure to make confirmation. The existence of bonds and mortgages, contracts, and loan agreements together with related documents such as insurance policies, tax bills, appraisals, etc., and the payment of cash or other consideration for their receipt is strong evidence of the existence of receivables at the date of their creation. The continued holding of such documents uncanceled, supplemented by appropriate test checks of related transactions during the period under review, may constitute persuasive evidence that the records continue to reflect the situation with reasonable accuracy. Any overstatement or understatement of the face amount of the asset could arise only from incorrect entry of subsequent receipts or charges relating to the receivables. The probability of errors or irregularities of this nature in an aggregate amount sufficient to affect substantially the validity of the statements as a whole may be rather remote. In view of these various considerations and in the absence of information from you which might lead to a contrary conclusion it seems that this may be a situation where the risk of misstatement inherent in the failure to carry out the confirmation procedure, may not be of sufficient moment to preclude expression of a qualified opinion. However, the independent public accountant is the one who must form the opinion and he should be the sole judge of whether he can give one, and he must, moreover, be prepared to assume the responsibility for any restricted opinion he does express.

"As a practical matter, there would seem to be a question whether any opinion which you might express (assuming you should express one) would meet the audit requirements of the Federal Home Loan Bank. The section of the rules and regulations which you quote states 'If a federal

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association is not audited at least once each year in a manner and by auditors satisfactory to the Board, the examination of such federal association shall include an audit.' It is stated on page 5 of the Institute bulletin 'Audit of Savings and Loan Associations,' that the Federal Home Loan Bank Board requires a minimum circularization of at least 10 per cent of the number and amount of each class of accounts. Thus an opinion so qualified presumably would not be 'satisfactory to the Board.' Perhaps your client's interest would be best served if, even at this late date, he instructed you to complete the examination to a point where it could meet the generally recognized auditing standard."

The general conclusion in the above letter seems clear. Although a particular and important auditing procedure in respect of a major portion of the assets may be omitted, under certain circumstances the other evidence existing and available to the auditor may be of sufficient weight to justify the auditor in expressing a properly qualified opinion. It is worthy of emphasis, however, that the sole responsibility for that opinion must rest with the independent public accountant; he must be the sole judge of whether he can give one and be prepared to assume responsibility for it.

The committee's conclusion in this case may be contrasted with that expressed in Bulletin No. 2, which dealt with the same question but under different circumstances. In the instant case the committee felt that, while all the evidence required by normal auditing procedures was not available to the auditor, nevertheless considerable evidence of a weighty character was available and this might justify the auditor in forming an opinion as to the existence and probable value of the related assets and as to the financial statements as a whole. The decision on this question was one for the auditor himself to make and the committee did not consider that he should be precluded from expressing an opinion if in the particular circumstances he had formed one.

On the other hand, in the case dealt with in Bulletin No. 2, the situation with relation to the greater portion of the current assets and a substantial portion of the operating transactions of the client was that the primary evidence which is normally required was to a major extent unavailable to the auditor, and his principal reliance in respect of these items would have to be upon the fact that the company was well and conservatively managed and that the particular items had been examined by the company's internal auditing staff. The absence of normal auditing procedures was almost complete in respect of the relative items because the auditor could not observe the inventory taking, confirm the receivables or have access to the detailed records in respect of either. The committee felt that there could not, in the circumstances, be sufficient evidence to warrant the expression of even a qualified professional opinion.

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It may also be noted that in the letter quoted on pages 80 to 82 attention was called to the practical aspects of the situation. While the committee felt that it could properly deal with the general aspects of the problem, it pointed out that it was doubtful whether any restricted opinion could satisfactorily serve the client's needs under the rules and regulations existing in this special field. The committee emphasizes the necessity of meeting the requirements of the governmental agency involved and suggests that the auditor shall urge his client to meet those requirements. The committee also calls attention to the importance of following the pertinent procedures set forth in the related bulletin on audit of savings and loan associations issued by the American Institute of Accountants.

While the committee deems it desirable to avoid restricted or qualified reports so far as possible, situations may arise, perhaps increasingly in the current emergency, in which it will not be practicable to carry out particular normal procedures. Under such circumstances the propriety of a restricted opinion becomes of greater current importance and the considerations involved in the above case may have more general applicability.

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